COMPETENCE PRACTICE EXAMINATION

NON AUDIT

DECEMBER 2010

SUGGESTED SOLUTIONS

QUESTION 1

SECTION A

1. The following aspects should have been considered before accepting the appointment. The safeguards have also been provided against each aspect considered.

· Kelvin is a trainee consultant and has been assigned to work in a professional capacity. He has been tasked to attend to the issues affecting the mining company and ensure that it is ready for audit. Mr. Banda being a registered chartered accountant should have taken steps and ensures that Kelvin who is operating in a professional capacity has appropriate training and supervision. As registered professional accountants, the issue of professional competence and due care must take the center stage when it comes to maintaining professional knowledge and acting diligently. PABs should have considered assigning a more competent consultant as a safeguard.

Safeguard: Mr. Banda should ensure that only those considered having appropriate professional knowledge and skill and sound professional competence are assigned on assignments. Similarly, Mr. Banda should ensure that adequate supervision is provided as a way of ensuring quality control on the work being carried out. The internal policy and procedures requiring compliance with professional competence and due care should be documented.

· Indications are that Mr. Banda seems to have a **close business relationship** arising from the fact that a procurement transaction took place for which an amount of K35 million was paid out to him. The client has also sought a refund of 40% for poor quality clothing supplied thereby prompting going into an agreement to have the 40% settled against the consultancy fees. This is also a **self-interest threat** considering that some kind of close business relationship seems to have been established with the client. It may also signify that the 40% recovery has been turned into a **loan** from an assurance client. The 40% can be considered to be significant. Though the **familiarity threat** may not be eminent, there seem to be some long association **(personal relationship)** with one of the directors of BJ & CO. On these grounds, PABs should not have accepted the appointment.

Safeguard: PABs should put in place policies and procedures that enable the identification of interests or relationships between the firm or members of engagement teams and clients such as quality control review to ensure that the independence is safeguarded.

· A self-interest threat may arise due to Mr. Banda involving himself in justifying the financing arrangements of the client. This arises from the fact that Mr. Banda is entitled to 5% of the profits generated by the client. Mr. Banda has also been promised a 10% shareholding in the company. The 10% is quite significant in relation to the shareholding structure. There is also a self-review threat arising from Mr. Banda's involvement in the corporate finance affairs. This is one way of assisting the client in defining corporate strategies, or possible sources of capital. PABs seems to have made some management decisions on behalf of BJ & CO. a conflict of interest is likely to arise.

Safeguards: Mr. Banda should avoid going into such agreements of 5% of profit generated by the client and 10% of shareholding as they are inconsistent with the ethical requirement for professional accountants in business. For instance, the 10% is likely to be material in as far as shareholding in a client's company is concerned. While Mr. Banda seems not to be part of the team doing the consultancy, he is the likely consultant who is going to review and possibly supervise the assignment. Where possible, he should not be part of the team. Ultimately, Mr. Banda should consider pulling out of this kind of arrangement which is detrimental to the ethical requirements.

· Kelvin has discovered that the client has not reported the discovery of Uranium to the authorities in line with the mining licence obtained. While the duty to report may conflict with confidentiality, it would be important to consider reporting this aspect of infringement under the obligatory disclosure. However, voluntary disclosure may also apply in order to protect the member's interest or required by the process of law or there is a public duty to disclose. Going by the information arising from Kelvin's review, the reporting may not be done as Mr. Banda has an interest in profits and shareholding. A conflict of interest is therefore eminent.

Safeguard: While confidentiality is an important aspect of ethical requirements, there are recognized exceptions to the rule of confidentiality that should be considered as a safeguard to this. This includes those outlined under obligatory and voluntary disclosure such those required under public interest or by law.

2 (a) **INCOME STATEMENT FOR THE YEAR ENDED 31 MARCH 2010**

	K, 000
Sales revenue (716,900 – 54,000)	662,900
Cost of sales (W1)	(417,100)
Gross profit	**245,800**
Distribution expenses	(57,400)
Administration expenses	(30,000)
Profit on disposal of land and buildings (190,000 – 160,000)	30,000
Loss on abandonment of research project	(60,000)
Finance cost (W3)	(22,400)
Profit before tax	106,000
Income tax (30,000 – 4,400)	(25,600)
Profit for the year	**80,400**

(b) **STATEMENT OF FINANCIAL POSITION AS AT MARCH 2010**

	K, 000	K, 000
Assets		
Tangible non - current assets		
Property (400,000 – 12,000 (W2)		388,000
Plant and equipment (W4)		320,000
		708,000
Current assets		
Inventories (56,480 + 45,000 (W1)	101,480	
Accounts receivable (110,000 – 54,000 (W1)	56,000	
Cash	21,320	
		178,800
Total assets		**886,800**
Equity and liabilities		
Equity		
Equity shares K50 each		300,000
Retained earnings (W5)		259,600
		559,600
Non-Current liabilities		
Leasing obligations (W6)	94,400	8%
loan interest	100,000	
		194,400
Current liabilities		
Trade and other accounts payable (W7)	102,800	
Income tax payable	30,000	
		132,800
Total equity and liabilities		**886,800**

WORKINGS:

1	**Cost of sales**	**K, 000**
	Per question	370,100
	Less sales/returns goods (54,000 x 100/120	(45,000)

	Add depreciation (W2)		<u>92,000</u>
			417,100

2. **Depreciation**

	K, 000	
Building (200,000 /50)	4,000	
Heating system (40,000/10)	4,000	
Lifts (60,000/15)	<u>4,000</u>	
	12,000	
Leased plant (160,000 x 20%)	32,000	
Owned plant (309,600 – 69,600) x 20%	<u>48,000</u>	
		92,000

3. **Finance cost**

	K, 000	
Loan note interest (100,000 x 8%)		8,000
Finance lease (160,000 – 40,000) x 12%	<u>14,400</u>	
		22,400

4. **Plant and equipment**

	K'000
Cost: Owned plant	309,600
Leased plant	<u>160,000</u>
	469,600
Depreciation: Owned plant (69,600 + 48,000 (W2)	(117,600)
Leased plant (160,000 x 20%)	(32,000)
	320,000

5. **Retained earnings**

	K'000
Balance b/f	143,200
Profit for the year	80,400
Profit on disposal of property (90,000 – 30,000)	60,000
Dividend paid	<u>(24,000)</u>
	259,600

6. **Leasing obligations**

Total payments due		160,000
Less amount paid		(40,000)
		120,000
Add accrued interest (120,000 x 12%)		14,400
Total creditor		134,400
Due within one year	40,000	
Due after one year		94,400

7. Trade and other payables

Trial balance	58,800
Lease creditor (W6)	40,000
Accrued loan note interest	4,000
	102,800

(c) Companies often used to justify the non-depreciation of buildings on several grounds, including:

- That the current value of the building was **higher than cost**
- That the level of **maintenance** meant that no deterioration or consumption had taken place
- That the depreciation charge would **not be material.**

However, IAS 16 requires the **depreciable amount** of an asset to be charged against profit over its useful life. That depreciation amount is obtained by comparing the cost of the asset with its **estimated residual value** at the end of its useful economic life. By requiring the residual value to be estimated at **current prices**, the standard removes any **potential inflationary** effects which would otherwise increase the residual value and hence reduce, even to zero, the depreciable amount. This overcomes the argument that high residual values remove the need for depreciation, unless the value of a second-hand asset has greater value than the same asset new – an unlikely proposition.

The argument regarding the **immateriality** of the depreciation charge because of a long economic life may have some validity. Although it is not addressed directly by IAS 16, accounting standards generally only apply to **material items**, according to the Framework. However, under this principle, it will be necessary to consider not only each year's potential depreciation charge, but also the **accumulated depreciation** that would need to be provided against the asset. Overtime, this latter amount would inevitably become material and the 'long life' argument would cease to hold. Thus BJ & CO's **previous policy** was not appropriate and the change to depreciation assets was necessary to comply with IAS 16.

The directors' proposed treatment of the deferred development expenditure is also incorrect. It needs to be written off because its **value** has become **impaired due to adverse legislation, not a change of accounting policy.** It now has no effective value. There has therefore not been a change of accounting policy, so it cannot be treated as a prior period adjustment. It must be written off to the income statement.

SECTION B

3. **Tax Adjusted profit for the charge year 2009/2010**

			K'000		**K'000**	
Net Profit					148,750	
Add:	Depreciation		58,000			
	Loss on sale of motor vehicles		9,500			
Donations		13,100				
Legal and professional fees		1,808				
NAPSA penalties		8,100				
PAYE penalties		3,200				
	Entertainment			21,000		
	Increase in general provision			2,400		
						117,108
						265,858
Less:	Reduction in general provision		1,750			
	Profit on sale of property		37,200			
	Unrealized exchange gain		7,347			
	Capital allowance (7,000 + 20,000)		27,000			
					73,297	
Tax adjusted loss				192,561		

Tax payable

Income Tax at 15% X 192,561 = **28,884.15**

Bob has made a profit thus should be able to pay **K28, 884.15** to the tax authority (ZRA). However, in the event that he made a loss, the requirement is that a company can carry forward losses for a maximum of 5 years. In the sixth year tax is expected to be paid.

4. **Capital allowances can be given in the following manner:**

According to the capital allowances rules, any implements, plant and machinery which are directly used by a farmer in farming qualify for wear and tear allowance at the rate of 50% and the implements are those only directly used in farming such as tractors, ploughs, farming implements and irrigation and harvesting implements.

In the case of Bob, he can get 50% wear and tear allowances for the pivot Center and combine harvester implements; farming implements and ploughs. The tractor is likely not to be used directly in farming thus can only qualify for wear and tear at a rate of 25%. The non- commercial vehicle can also only qualify for 20% wear and tear.

In the case of the commercial vehicles, the normal depreciation would apply and depreciation is not an allowable expense. The wear and tear allowance is normally pegged at 25%.

5. **Other allowances to be given to a farming enterprise:**

(a) Farm improvement allowance can be given on cost of the farm improvements expenditure at a rate of 100%. The expenditure should be on:

· Construction of barns and other storage buildings

· Construction of farm dwellings

· Fencing

· Construction of buildings for the welfare of employees

However, expenditure incurred on construction of farm dwellings is limited to a maximum cap of K20, 000,000 per dwelling. Other restrictions may apply.

(b) A farm works allowance is available at a rate of 100% on the expenditure incurred on farm works and may relate to expenditure incurred on:

· Works for prevention of soil erosion

· Carry out aerial or geographical survey

· Wells, boreholes

· Stumping and clearing

· Water conservation.

(c) A development allowance of 10% of expenditure incurred on development of a plantation is given as a deduction against the profits of the charge year in which expenditure is incurred. Examples include tea plantations, coffee and cocoa plantation, oranges and other citrus fruits plantation. Expenditure incurred on rose flowers may also qualify.

QUESTION 2

SECTION A

1. According to the Zambia Tax regime, about five types of taxes can be found in Zambia and have been outlined below and classified accordingly.

Director taxes – these are taxes levied directly on the income and gains. This includes:

(a) **Income tax** to mean tax that is levied on income and not on capital. It is chargeable on the income of persons resident and ordinarily resident in Zambia. Persons include both individuals and companies. For PAYE method, employees pay tax using tax bands. Others include self assessment, withholding tax, turnover tax and presumptive tax.

(b) **Mineral royalty tax** arising from the exploration of mineral mostly in the mining sector. It is payable by companies involved in the exploration of minerals in Zambia. A flat rate is normally paid.

(c) **Property Transfer Tax** is tax chargeable on any person who transfers property to another person. It is normally chargeable at the rate of 3% of the realized value of the property and it is payable by the transferor and should be paid within 14 days from the date when the transaction is completed.

Indirect taxes – are taxes that are imposed indirectly. They are expenditure taxes and are thus born by customers. This includes:

(d) **Value Added Tax** is tax levied on expenditure and not a tax on income. It is tax on the turnover of taxable supplies of goods and services made in Zambia by a registered person in the course or furtherance of any business carried on by him. A non registered trader cannot charge VAT. Zero rated supplies are charged at 0%, whereas standard rated supplies are charged at 16%.

Capital taxes – are taxes on capital receipt resulting from a disposal of a capital item.
The **property transfer tax** outlined above is an example of a capital tax.

Revenue taxes – are taxes levied on revenue receipts which is a receipt arising from a sale of a non-capital item. An example of a revenue tax is **income tax** already outlined above.

Regressive taxes – are those that represent a smaller proportion of a person's income as the income of that person rises. **VAT** is an example of regressive tax.

Progressive taxes – are taxes that represent a larger proportion of the person's income as that person's income rises. Normally the rates of tax for lower income levels are less than the tax rates for higher income levels. **Income tax** is an example.

There are also customs and excise duties:

· Customs duty is the duty payable on imported goods and on exports. It is based on the customs value of the goods which is known as the value for duty purposes. Various rates are used depending on the item bought.

· Excise duty is the duty payable on certain imported goods and on locally manufactured goods. It is based on the value for duty purposes for excise duty. Various rates are also used depending on the item in question.

2. The report should start with a proper format.

Mr. Tembo,

This report clearly outlines and explains the benefits that may arise from the commercial farming and manufacturing trade ventures that you want to engage in. The report first outlines the farming aspects and progresses to manufacturing trade aspects.

Commercial farming aspects:

The benefits outlined below are only applicable to farming enterprises whose annual turnover is over K200 million. For a turnover of less than K200 million, then the farming enterprise is subjected to turnover tax. It is assumed here that Mr. Tembo will exceed the K200 million turnover considering the kind of money he is planning to invest in this activity.

Going by the information provided, and amounts to be invested in farming, an amount of K700 million [K2 000 million – (500 + 200 + 100 + 500)] will be used to buy a farm. This will not be subjected to property transfer tax because you will be assumed to be the transferee. Property transfer tax will be paid by the transferor, meaning where you will buy a farm from. However, benefits may arise under the Zambia Development Agency for investors investing in Zambia for certain amounts categorized. Arising to the information that you collected from ZDA, it is possible that the K700 million investments may attract certain incentives. From the specific activities outlined, the following benefits may arise:

(a) For the K500 million to be used to buy a tractor, this falls under farm implements. Tear and wear allowance of 50% is applicable to farm implements. However, the tractor will be used for ploughing and also leasing out to other farmers. This means that this kind of implement will not be directly used in farming thus can only qualify for wear and tear at the rate of 25%. The 25% wear and tear amounts to K125 million capital allowance to be given before arriving at adjustable taxable profits.

(b) For the K200 million to be used to buy a non-commercial vehicle, you should be able to qualify for wear and tear of 20% on this investment. This will amount to K40 million capital allowances given.

(c) For the K100 million and K500 million to be used to buy ploughs and irrigation and harvesting implements, these qualify for a wear and tear allowance of 50%. This means that capital allowances amounting to K50 million and K250 million will be given.

(d) Information also indicates that an amount of K200 million will be used for farm improvements, K100 million on fencing the farm and another K100 million will be spent on constructing a farm dwellings. As long as these qualify as farm improvements under the Act, a rate of 100% of expenditure is given on the cost of the farm improvement as farm improvement allowance. Forthwith, expenditure incurred on fencing the farm will qualify for a 100% farm improvement allowance. As for the expenditure on the construction of farm dwellings, the maximum amount qualifying for this kind of allowance is K20 million per dwelling even if the cost of construction exceeds K20 million. However, where the expenditure is partly incurred in respect of farm improvements and partly for other purposes, then the Commissioner General will determine the part that qualified for the allowance.

(e) As for the additional K50 million to be used on farm works by digging two boreholes and a well, a farm works allowance is available at the rate of 100% on the expenditure incurred on farm works. Thus an allowance of K50 million will be allowed. Similarly, a development allowance of 10% is given on development expenditure. This amounts to K1 million to be allowed.

Manufacturing Trade:

While the industrial building qualifies for capital allowances, there are some limitations that need to be acknowledged before arriving at the capital allowance to be given. The K300 million to be used for land purchase will not form part of the qualifying cost. Similarly, the government grant will as well not qualify. The show room can qualify as long as the cost of the show room does not exceed 10% of the total construction cost of the structure. The total construction cost will be K550 million (K1000million – 300 – 150). 10% of this cost is K55 million (550 x 10%). Considering that the cost of the showroom exceeds the 10% limit, then it must be removed from the total construction cost. The cost qualifying for industrial building allowances will therefore be K490 million (550 – 60).

The industrial building allowances will therefore be K122.5 million calculated as follows:

Initial allowance – 10% x 490 million	49 million
Investment allowance – 10% x 490 million	49 million
Wear and tear allowance – 5% x 490 million	24.5 million.

Conclusion

Arising from the above projections, you should be able to receive K758.5 million of allowance to be allowed from the profits before adjustable tax profit. This also justifies the reasoning behind treating the above items as qualifying for capital allowances under farming, i.e. turnover of above K200 million. However, if the capital allowance become excessive, it may mean that Mr. Tembo will incur losses and thus not taxable until a period of five years.

3. Taxes and person/organization exempt from paying taxes include:

Taxable income:

- The business of letting properties in Zambia. This results into rental income
- Profits or gains derived from a business
- Going into mining and related activities. This result into paying royalties
- Investing in securities such as shares. Dividends paid is taxable
- Financing through loans and debenture. Interest received is taxable
- Emoluments from holding an office or from being employed
- Investing money in the banks and building societies. Interest received is taxable

Persons/organizations

Person who are not resident in Zambia are exempt from Zambia Income Tax. However, certain other persons are listed below are also exempt from paying income tax though residents.

· Republican President on income received as President

· Income of chiefs from government

· Local authorities

· Approved funds

· Club, society or association organized and operated only for social welfare or recreation and improvements.

SECTION B

4. In relation to (a), yes the standard in question is IAS 7 and is termed "Statement of Cash Flows" and not "Cash Flow Statements". The standard prescribes the presentation of a statement of cash flow disclosing information about the historical changes in cash and cash equivalents of an entity over the reporting period. The cash flow statement is an integral part of an entity's financial reporting for each period for which a financial report is presented. It provides an insight into an entity's ability to generate cash and its needs to utilize these cash flows.

In terms of classification, cash flows are classified as relating to **operating activities; investing activities** and **financing activities.**

Operating activities are normally derived from the main revenue activities of the entity and generally results from the transactions and other events that determine profit or loss. They are key indicators of the extent to which the entity's operations have generated sufficient cash flows to repay loans, maintain operating capability, pay dividends and make new investments without recourse to external sources of financing.

Investing activities represents the extent to which expenditures are made to generate future income and cash flows, e.g. cash payments to acquire investments and property.

Financing activities help to predict the claims on future cash flows by providers of capital to the entity. For example cash proceeds from shares issues.

However, cash flow items may differ in classification as a result of specific industry and entity practices and so IAS 7 permits some flexibility.

In terms of reporting methods, the standard requires that cash flows from operating activities be reported using the **direct method** or **indirect method**.

In relation to (a) (i) to (iii), the following answers and clarifications are provided.

(i) The dividends should be disclosed either as operating cash inflow or as investing cash inflow.

(ii) The gain should be treated as an adjustment to the net income in the operating activities section of the cash flow statement.

(iii) Yes, room for manipulation, misclassification or abuse in terms of classifying cash flows in a manner that enhances operating cash flows is there. For instance, cash flows that should have been reported in the operating section may be classified as investing cash outflows. It can also arise from the type of method chosen.

In relation to (b) on accounting and related issues, IAS 16, Property, Plant and Equipment are tangible assets that an entity holds for its use or for rental to others. These are expected to be used for more than one period. These could be constructed by the reporting entity or purchased from other entities. The plant and equipment Mr. Tembo has mentioned qualify as plant and equipment under the standard and should be recognized as assets initially at its cost, the fair value of the consideration given. After initial recognition, the asset should be measured at cost less accumulated depreciation and impairment losses or at revalued amount, which is its fair value less subsequent depreciation and impairment losses. However, IAS 16 does not include biological assets, intangible assets and investment property as part of property, plant and equipment.

As for the plant that will be constructed, all the directly attributable costs necessary to bring the asset into working condition should be capitalized. These should include all costs attributed to constructing the plant including architects' fees.

In terms of revaluations, the standard requires that if an asset is revalued, then the entire class of asset must be revalued. The fair value of property is its market value. However, it is important to note that a professional qualified valuer normally undertakes the valuation.

In relation to IFRS for SMEs under (c) on accounting and related issues, the standards provide a framework that generates relevant, reliable and useful information, which provide a high-quality and understandable set of accounting standards suitable for SMEs.

IFRS for SMEs is a self-contained standard, incorporating accounting principles based on existing IFRSs, which have been simplified to suit the entities that fall within its scope. Certain accounting treatments are not allowed under the standard such as revaluation model for property, plant and equipment, intangible assets and proportionate consolidation for investments in jointly controlled entities.

The standard for SMEs is by nature not an independently developed set of standards. It is based on recognized concepts and pervasive principles and it allows easier transition to full IFRS if the SME later becomes a public listed entity.
The standard relaxes some of the measurement and recognition criteria in IFRS in order to achieve the reduction in these costs and burdens. This is by nature that users of financial statements of SMEs often do not need full disclosures like that required for listed entities.

5. First, the Consultant seems not to have been aware about the friendship that subsists between Mr. Tembo and Todd. Secondly, the information indicates that Mr. Todd has been dealing in high level prohibited substances through a friend in USA. Until when it is established, it would not be ideal to pull out of the consultancy. There are no facts to indicate that the friend is Mr. Tembo. Whereas it is a requirement under the money laundering Act that suspicion of money laundering should be reported to the necessary authorities such as the DEC, it could be premature for the Consultant to do so. However, the consultant should observe with keen interest to establish as to whether there are signs that could indicate money laundering activities with his client. The ethical guidance requires that accountants such as the Consultant in question should be aware of the local legal frameworks and the basic procedures to be applied.

It could also be important for the Consultant to revisit the various requirements and procedures pertaining to money laundering in Zambia. This should enable him to establish, if at all, there are signs that his client is involved in money laundering. In essence, Mr. Tembo has not yet started business in Zambia. This means that no money yet has been invested in Zambia as a cleaning process of the dirty money.

It could be deduced from the various assignments given to the Consultant that the Consultant could be drawing quite substantial fees from Mr. Tembo thus relying so much on the revenue arising from one client. However, we are not told how much the Consultant is drawing from him.

There seems also to be signs of inducement arising from the friend to Mr. Tembo concerning the offer to fly to Dubai for a special meeting concerning business prospects and future areas of co-operations. This possesses a threat to the Consultant in as far as relationships are concerned.

Money laundering is the process by which criminals attempt to conceal the true origin and ownership of the proceeds of their criminal activity, allowing them to maintain control over the proceeds and ultimately providing a legitimate cover for their source of income.

END OF SOLUTIONS